DEPARTMENT OF STATE REVENUE

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Letter of Findings: 07-0380
Sales and Use Tax
For the Years 2004, 2005, 2006

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ISSUES

I. Sales and Use Tax – Exemptions – Utilities Consumed in Manufacturing.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-4-5; IC § 6-2.5-5-5.1; IC § 6-8.1-5-1; 45 IAC 2.2-5-12; 45 IAC 2.2-4-13; *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Mynsberge v. Indiana Dep't of State Revenue*, 716 N.E.2d 629 (Ind. Tax Ct. 1999).

Taxpayer protests the imposition of use tax on some items.

II. Tax Administration – Imposition of Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

The Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer, an Indiana corporation, sells thermoplastic resins to manufacturers of power tools, lawn and garden equipment, appliances, automobiles, HVAC, electronics and construction materials. Taxpayer contracted with a then unrelated compounder ("Company B") to process the raw materials Taxpayer had purchased into a finished product which Taxpayer then sold to its customers. Taxpayer received the raw materials, unloaded and stored the raw materials, transferred the raw materials to Company B's blending stations that processed the materials into the finished product, transported and warehoused the finished product, and finally shipped the finished product to its customers. Taxpayer and Company B were physically located in the same building, which Taxpayer owned.

The Indiana Department of Revenue ("Department") completed a sales and use tax audit of Taxpayer on May 16, 2007. The Department's audit concluded that Taxpayer had no taxable sales. However, the Department's review of Taxpayer's purchase invoices resulted in the assessment of use tax on some items, including the consumption of utilities.

Taxpayer protested the assessment of use tax on its consumption of utilities arguing that it qualified for the sales and use tax utility exemption. A hearing was held and additional time was allowed for Taxpayer to provide additional documentation. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Exemptions – Utilities Consumed in Manufacturing.

DISCUSSION

On initial review, the Department determined that Taxpayer did not qualify for the utilities exemption because, while it purchased the electricity, it did not itself consume the electricity in the processing of the plastic pellets. The Department reasoned that it was Company B that directly consumed the utilities in directly producing the pellets, not Taxpayer, and therefore, it was Company B that would qualify for the exemption. Consequently, the Department's audit made adjustments to assess Taxpayer use tax on gas and electric meters previously refunded in error by the Department. The Department's audit also assessed use tax on electric meters the Department had previously exempted in error for the period May through December of 2006.

Taxpayer protested the assessment arguing, in a letter dated August 14, 2007, that throughout the whole process it owned all the raw material, work-in-process material, and the finished goods which it sold to its customers. Taxpayer stated that it purchased the utilities and argued that it also consumed the utilities when it used them to manufacture its products. Taxpayer argued that Company B was merely acting on its behalf when it processed the plastics, therefore Taxpayer was also the consumer of the utilities. Therefore, Taxpayer reasoned, it should qualify for the utility exemption.

All tax assessments are prima facie evidence that the Department's assessment of tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-2-1.

IC § 6-2.5-4-5 governs which sales of utilities are retail transactions and which sales of utilities are not. Subsection IC § 6-2.5-4-5(b) states the general rule that brings the sales of utilities within the definition of a retail transaction. Subsection IC § 6-2.5-4-5(c) states an exclusion from subsection (b).

IC § 6-2.5-4-5 states in relevant part:

(a) As used in this section, a "power subsidiary" means a corporation which is owned or controlled by one (1) or more public utilities that furnish or sell electrical energy, natural or artificial gas, water, steam, or steam heat and which produces power exclusively for the use of those public utilities.

(b) A power subsidiary or a person engaged as a public utility is a retail merchant making a retail transaction when the subsidiary or person furnishes or sells electrical energy, natural or artificial gas, water, steam, or steam heating service to a person for commercial or domestic consumption.

(c) Notwithstanding subsection (b), a power subsidiary or a person engaged as a public utility is not a retail merchant making a retail transaction in any of the following transactions:

[...]

(3) The power subsidiary or person sells the services or commodities listed in subsection (b) to a person for use in manufacturing, mining, production, refining, oil extraction, mineral extraction, irrigation, agriculture, or horticulture. However, this exclusion for sales of the services and commodities only applies if the services are consumed as an essential and integral part of an integrated process that produces tangible personal property and those sales are separately metered for the excepted uses listed in this subdivision, or if those sales are not separately metered but *are predominately used by the purchaser* for the excepted uses listed in this subdivision.

(*Emphasis added*).

IC § 6-2.5-5-5.1 sets out the general rule that purchases of utilities are subject to sales and use taxes. IC § 6-2.5-5-5.1 (b) states the exemption from sales tax on the purchase of utilities acquired for direct consumption in direct production. IC § 6-2.5-5-5.1 states:

(a) As used in this section, "tangible personal property" includes electrical energy, natural or artificial gas, water, steam, and steam heat.

(b) Transactions involving tangible personal property are *exempt* from the state gross retail tax *if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production* of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture. This exemption includes transactions involving acquisitions of tangible personal property used in commercial printing.

(*Emphasis added*).

45 IAC 2.2-4-13 elaborates on which utilities furnished to industrial consumers are exempt sales and use tax. It states:

(a) In general, the furnishing of electricity, gas, water, steam, or steam heating services by public utilities to consumers is subject to tax.

(b) The gross receipt of every person engaged as a power subsidiary or a public utility derived from selling electrical energy, gas, water, or steam to consumers for direct use in direct manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5 shall not constitute gross retail income of a retail merchant received from a retail transaction. Electrical energy, gas, water, or steam will only be considered directly used in direct production, manufacturing, mining, refining, oil or mineral extraction, irrigation, agriculture, or horticulture if the utilities would be exempt under IC 6-2.5-5-5.1.

(c) Sales of public utility services or commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, horticulture, or another public utility or power subsidiary described in IC 6-2.5-4-5, based on a single meter charge, flat rate charge, or other charge, are excepted if such services are separately metered or billed and will be used predominantly for the excepted purposes.

(d) Sales of public utility services and commodities to consumers engaged in manufacturing, mining, production, refining, oil or mineral extraction, irrigation, agriculture, or horticulture, based on a single meter charge, flat rate charge, or other charge, which will be used for both excepted and nonexcepted purposes are taxable unless such services and commodities are used predominantly for excepted purposes.

(e) Where public utility services are sold from a single meter and the services or commodities are utilized for both exempt and nonexempt uses, the entire gross receipts will be subject to tax unless the services or commodities are used predominantly for excepted purposes. Predominant use shall mean that more than fifty percent (50%) of the utility services and commodities are consumed for excepted uses.

45 IAC 2.2-5-12 addresses sales of tangible personal property directly consumed in manufacturing:

(a) The state gross retail tax shall not apply to sales of any tangible personal property consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing, processing, refining, or mining.

(b) The exemption provided by this regulation *[45 IAC 2.2]* applies only to tangible personal property to be directly consumed in direct production by manufacturing, processing, refining, or mining. It does not apply to machinery, tools, and equipment used in direct production or to materials incorporated into the tangible personal property produced.

(c) The state gross retail tax does not apply to purchases of materials to be directly consumed in the production process [...] provided that such materials are directly used in the production process; i.e., they have an immediate effect on the article being produced. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces tangible personal property.

(d) Pre-production and post-production activities.

(1) *Direct consumption in the production process begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production process has altered the item to its completed form, including packaging, if required.*

[...]

(e) "Have an immediate effect upon the article being produced or mined." Purchases of materials to be consumed during the production or mining process are exempt from tax, if the consumption of such materials has an immediate effect upon the article being produced and mined, or upon machinery, tools, or equipment which are both used in the direct production or mining process and are exempt from tax under these regulations *[45 IAC 2.2]*.

(*Emphasis added*).

As a preliminary matter, it should be noted that Taxpayer had a utility study done on its electrical and gas meters in 2004 that showed ninety-percent of the utilities consumed in processing the plastic pellets (this Letter of Findings does not address the parameters of the study itself, but simply notes that the study was performed). Interestingly, the study identifies machinery used in a production process, but does not identify that the machinery is actually Company B's and not Taxpayer's.

Based on the above, Taxpayer was clearly purchasing utilities in a retail transaction. IC § 6-2.5-4-5(b). As for the exemption of utilities directly consumed in the direct production of the plastic pellets, there are three relevant questions: (1) when did the production process begin and end, and (2) who consumed the utilities, and (3) who purchased the utilities?

45 IAC 2.2-5-12(e) allows for exemption of utilities consumed directly during the production process if the consumption of the electricity has an immediate effect on the articles being produced.

The Department had referred Taxpayer to *Mynsberge v. Indiana Dep't of State Revenue*, 716 N.E.2d 629 (Ind. Tax Ct. 1999) in support of its initial determination that Taxpayer did not qualify for the exemption because while it purchased the utilities, it did not itself directly consume them in the direct production of the plastic pellets. The facts of the case are as follows:

Mr. Mynsberge leased buildings and equipment to Coppes Nappanee (Coppes), a manufacturer of kitchen cabinets, as part of his leasing business. Mynsberge was billed by the utility company for electricity usage. Mynsberge paid the bill. Under agreement with Mynsberge, Coppes made a flat monthly payment to Mynsberge for electricity Coppes used in its manufacturing business (Coppes showed predominant use in manufacturing). According to the agreement between Mynsberge and Coppes, if the bill for Coppes' electrical usage was less than the flat rate it had paid Mynsberge for the month, Mynsberge refunded 75-percent of the difference to Coppes. *Id*. at 631.

The tax court stated that the Indiana legislature expressly limited this exclusion and held that the utility exemption applies only when the purchaser of the utility services and commodities also consumes those services and commodities.

Taxpayer distinguished its case from the facts of *Mynsberge*. Taxpayer argued that Mynsberge only owned the building and nothing else. Here, Taxpayer owns the building, but also the materials; i.e., it is Taxpayer's process and Taxpayer has simply hired Company B to perform the process on Taxpayer's behalf.

In light of all of the above, even though Taxpayer owned the materials throughout the whole process, all Taxpayer's activities relating to the raw materials, referred to above, were not involved in the direct production process. 45 IAC 2.2-5-12(d)(1). The integrated production process begins with the introduction of the raw materials into Company B's processing machinery and ends when the raw materials are transformed into the final marketable product by Company B. 45 IAC 2.2-5-12(d)(1). The integrated production process begins and ends with Company B. Taxpayer is not directly involved in those activities. Taxpayer's activities relating to the production process of the plastic pellets – receiving, storage, transportation and shipping - were pre-production and post-production functions. 45 IAC 2.2-5-12(d)(1). Since the entity that directly transformed the raw materials into plastic pellets - the finished product - was Company B, it follows, then, that it was Company B that also directly consumed the utilities used in the direct production of the plastic pellets.

Furthermore, while the utility meters were in Taxpayer's name and Taxpayer paid the utility bills, Taxpayer stated at hearing that it charged back the utility expenses to Company B. Indeed, Taxpayer provided copies of checks it received from Company B for each of the years in question which state in the memo section of the checks an annual utility reimbursement (except for the 2005 checks which do not have any notations in the memo section of the checks). Therefore, the purchaser of the utilities was ultimately Company B. As the purchaser and consumer of the utilities, it is Company B that qualifies for the exemption.

Based on the above, the Department correctly found that Taxpayer did not qualify for any exclusion of or exemption from use tax.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration – Imposition of Negligence Penalty.

DISCUSSION

The Taxpayer also protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has established, as required by 45 IAC 15-11-2(c), that its failure to pay sales tax on the purchase of utilities was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest is sustained.

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